No. 81.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

OTIS & CO., *Petitioner*,

v.

SECURITIES AND EXCHANGE COMMISSION AND THE UNITED LIGHT AND POWER COMPANY, *Respondents*.

BRIEF FOR RESPONDENT, THE UNITED LIGHT AND POWER COMPANY.

(On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.)

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OPINIONS BELOW.

The opinion of the United States District Court for the District of Delaware, approving the plan submitted by the United Light and Power Company, which had been approved by the Securities and Exchange Commission (R. 2), is reported in 51 F. Supp. 217; and appears in the Record at page 82.

The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 123) affirming the judgment of the District Court is reported in 142 F. (2d) 411 (under the title of "*In re Securities and Exchange Commission*"). (R. 123)

ADDITIONAL STATEMENT OF THE CASE.

The facts are not in dispute but petitioner's statement is inadequate for a proper understanding of the issues. The following facts are pertinent:

By an application filed on July 24, 1940, and amended October 19, 1940, The United Light and Power Company (hereinafter called "Power") submitted to the Commission for its approval a Plan of Recapitalization and Simplification under Section 11(e) of the Public Utility Holding Company Act of 1935 (hereinafter called the "Act"), which provided for a reduction in the capital of Power, the creation of an adequate reserve for depreciation of investments and the reclassification of the preferred and common stocks of that company into a single class of new common stock. The plan was proposed in order to simplify the capital structure of Power, to distribute voting power fairly and equitably among all of its stockholders and to place the company in a position to pay dividends to the extent earnings might permit, no dividends having been paid since 1932. In this plan, the management of Power, after careful and impartial consideration of the interests of all stockholders, proposed a division of the new common stock on a basis substantially as follows: 91.20 per cent to the preferred stockholders, 6.13 per cent to the Class A common stockholders, and 2.67 per cent to the Class B common stockholders. (R. 106)

On December 6, 1940, before a hearing was held on the Plan of Recapitalization and Simplification, the Commission instituted proceedings to determine what action Power and its subsidiaries, including The United Light and Railways Company (hereinafter called "Railways") must take

to comply with Section 11(b)(2) of the Act. These proceedings were consolidated with the proceedings relating to the Plan of Recapitalization and Simplification above referred to, and the proceedings were also subsequently consolidated with proceedings which had been instituted by the Commission on March 8, 1940, under Section 11(b)(1) of the Act.

Since the holding company system did not meet the standards prescribed by the second sentence of Section 11(b)(2), the Commission decided that before passing on the Plan of Recapitalization and Simplification it should first determine what action should be taken to bring the holding company system into compliance with that sentence of the Act and, after considering alternative methods of compliance, an order was entered on March 20, 1941, requiring the liquidation and dissolution of Power. (R. 105-120) Thus, the Plan of Recapitalization and Simplification was abandoned and action was initiated to comply with the dissolution order which required Power to proceed with due diligence to carry out its terms. No appeal was taken by anyone from the Commission's order of March 20, 1941, and that order is not now subject to judicial review.

Power and Railways, together with other companies in the holding company system, then completed a series of transactions the consummation of which was necessary to place Power in a position to liquidate and dissolve. As a result, Power paid or became discharged of further liability on its bonds and debentures and placed itself in a position to complete its liquidation by distributing among its stockholders the common stock of Railways, all of which is owned by Power, and by contributing to Railways all other assets of Power. To accomplish this final step, the plan now involved in litigation was submitted to the Commission on July 1, 1942. It originally provided that 91.2 per cent of the common stock of Railways should be distributed to Power's preferred stockholders and that 8.8 per cent thereof should be distributed to its common stockholders,

being the same allocation as that previously proposed in the Plan of Recapitalization and Simplification filed in 1940.

The Commission, in its findings and opinion entered April 1, 1943, concluded that it would not approve the plan unless it was amended to reduce the participation of the common stockholders to approximately 5 per cent, and Power and Railways amended the plan to conform to the Commission's views. The plan as amended provides that the par value of the outstanding common stock of Railways shall be reduced; that the number of shares of such stock shall be increased; that 94.52 per cent of the new common stock of Railways shall be distributed to the preferred stockholders of Power, and 5.48 per cent thereof to the common stockholders; and that all other assets of Power shall be contributed to Railways.

On April 5, 1943, the Commission entered its supplemental findings and opinion and an order approving the plan as amended. On April 16, 1943, the Commission applied to the District Court of the United States for the District of Delaware for an order approving and enforcing the plan, and on August 4, 1943, that Court approved the plan.

On August 25, 1943, Otis & Co., as the holder of ten shares of preferred stock of Power, filed an appeal from the order of the District Court with the United States Circuit Court of Appeals for the Third Circuit, contending that the plan was not fair and equitable to the preferred stockholders of Power because it permitted the common stockholders to participate in the distribution. The Circuit Court of Appeals affirmed the action of the District Court in an opinion rendered on April 20, 1944. No other preferred stockholder and no common stockholder appealed from the order of the Commission or the order of the District Court.

On May 11, 1944, Otis & Co. filed a petition for a writ of certiorari with this Court, which granted the petition on June 12, 1944.

We call attention to these significant facts: (1) That the distribution of Railways' common stock originally proposed in the plan now being reviewed was the same as that which had been proposed in the recapitalization plan submitted by Power in 1940; (2) that before submitting its plan of 1940, the management of Power had carefully canvassed the situation and weighed the respective rights of the different classes of stockholders of Power in order to propose a division of interests which would appeal to the different classes of stockholders as fair and equitable; (3) that the possibility of such a division of interest has been made evident to the stockholders of Power ever since 1940 and, from the absence of any significant opposition thereto, might properly be regarded as generally satisfactory to these stockholders; (4) that the absence of any opposition among the stockholders (both preferred and common) to the proposed division of interests throughout the consideration thereof by the Commission gives strong evidence of widespread acceptance by the stockholders of such a division as thoroughly fair and equitable; (5) that the present insignificant opposition of one small stockholder (Otis & Co. is the owner of only *ten* shares of preferred stock, R. 96) to the order of the District Court gives convincing evidence that the preferred stockholders, as a class, are satisfied with the percentage of interest in the common stock of Railways which has been allotted to them.

Counsel for petitioner are inexcusably inaccurate in referring to the plan under review as a "common stock plan" (Brief, page 3) and in describing the management of Power as a "common stock management". (Brief, page 12) Although the management was elected by common stockholders, it proposed from the beginning a reorganization in which the preferred stockholders would receive over 90 per cent of the new voting stock. The management sought impartially to fulfill its duty to all stockholders of Power and certainly showed no partiality for the common stockholders in proposing to reduce their present interest in owning and voting to a very small percentage.

The Interest of Otis & Co., Petitioner.

Throughout the proceedings before the Commission, Otis & Co., the present petitioner, was the owner of its entire present stock holding, that is, *ten shares* of preferred stock. But the record shows no opposition by Otis & Co. to the liquidation of Power as proposed or as approved by the Commission. There was no appeal taken from the order of the Commission of March 20, 1941 requiring the liquidation of Power. There was no appeal by Otis & Co. or by any other person from the order of the Commission approving the plan for liquidation. The Commission, responding to the request made by Power in submitting its plan, made application to the District Court of the United States for the District of Delaware to enforce and carry out the terms of the modified plan which had been approved by the Commission. The District Court required notice to be given to all stockholders of Power and required that any objections to the consummation of the plan approved by the Commission should be filed and served on or before June 1, 1943.

Otis & Co. offered their first opposition to the plan on June 10, 1943, ten days after they were in default, but five days prior to the hearing held June 15th, in which the District Court permitted Otis & Co. to be heard. After the District Court entered its order approving the plan on August 4, 1943, Otis & Co. appealed to the United States Circuit Court of Appeals for the Third Circuit.

Counsel for Power do not call attention to these facts as the basis for again arguing that the writ of certiorari should be denied because petitioner's interest is so trifling and insubstantial. But these facts do provide the basis for urging that substantial evidence that the plan approved by the Commission is fair and equitable may be found in the fact that objection has been raised only by the owner of 10 shares of preferred stock out of a total of 600,000 shares outstanding and that no objection has been made by the owners of 3,476,760 shares of common stock.

Furthermore, the petitioner, the present objector, with full knowledge that the management proposed a similar but slightly smaller distribution to preferred stockholders in 1940, and again in 1942, recorded no opposition throughout the lengthy proceedings before the Commission (although having ample notice thereof). Only after being ten days in default in the District Court Otis & Co. sought at the eleventh hour to upset, or at least to delay, consummation of the efforts of the Commission and the company management to comply with the law in a manner fair to all concerned. The unfair character of such opposition discredits petitioner's judgment as to what is "fair and equitable."

The Facts Relating to Liquidation.

Since the entire argument of petitioner is based on the technical proposition that Power is being "liquidated" and that the charter rights of preferred stockholders in a liquidation have been disregarded, it is pertinent to review the proceedings which led to the order of March 20, 1941. Such a review will demonstrate that the *enterprise* in which the stockholders of Power invested their money is not being liquidated and that their investment in that enterprise is not being discontinued. In substance and in fact, the security structure of the enterprise is merely being readjusted to meet new congressional standards; and the investment of all stockholders in the enterprise is being continued. A review of the proceedings will demonstrate that the dissolution of Power was not inevitable, in order to comply with the law, but was ordered as the most practical of several available methods of accomplishing the same result. Dissolution of the top company was ordered only because it was the most feasible method of complying with the law without doing violence to the rights and interests of thousands of investors in this holding company system.

The record shows that the Commission considered three alternative methods of compliance with the law and finally decided that the elimination of Power was the most prac-

tical and expeditious method. This dissolution was not required by any insolvency or financial stress of Power and was not motivated by any desire or intention to discontinue the business. It was only required because, to comply with the Act, it was necessary to simplify the structure of the United System and necessary to eliminate one or more of the holding companies in that System. The many proceedings in the past and now pending before the Securities and Exchange Commission affecting the United System are all parts of a program of reorganization largely necessitated by the requirements of the Act. It will be appropriate, therefore, in the following argument, to call attention to the facts of record showing that what is here under consideration is a "liquidation" in name only and is in substance and in fact a reorganization.

We contend that a charter provision intended to determine the rights of stockholders upon the happening of a specified contingency should not be invoked to determine their rights upon the happening of other contingencies of a different nature, and particularly where the contingency which occurs was not of a type anticipated by the parties. It should be pointed out that the *common* stockholders of Power, as well as the preferred stockholders, of Power, have definite legal and contract rights which must be respected. These rights are created by the charter itself and by the laws of Maryland to which the charter is subject. If the substance (and not the mere form) of the action here involved controls the rights of the parties, as we believe it should, it is clear that the plan does not violate any contract or legal rights of the preferred stockholders. Under Maryland law, a recapitalization or reorganization to accomplish the purposes to be accomplished by the plan here involved could be consummated with the consent of the holders of a majority of the stock of each class; and the charter provision governing the rights of the parties upon voluntary or involuntary liquidation would have no bearing on the matter. In effect, Otis & Co. asks this court to

disregard all legal and contract rights of the *common* stockholders and to consider only one contract right which the preferred stockholders would have upon the happening of an event which is not in fact taking place.

SUMMARY OF ARGUMENT.

I. The plan approved by the Commission and the courts below was "fair and equitable" and "appropriate to effectuate the provisions of Section 11" of the Act in accordance with the requirements of said Section 11.

II. The "absolute priority" rule, as applied in the bankruptcy cases, which is relied upon by petitioner, does not control the discretion of the Commission in approving a plan designed to readjust the corporate structure of a continuing enterprise in order to meet the requirements of the Act.

III. "Fair and equitable" under the Act is not a formula but a standard for the exercise of administrative discretion. The objection of the owner of 10 shares of preferred stock out of 600,000 shares should not prevail over the judgment, as to what is "fair and equitable", of the owners of 599,990 shares (expressed by their silent assent), the judgment of the corporate management, the opinion of the Commission, and decision of the District Court supported by the review of the Circuit Court of Appeals.

ARGUMENT.

I.

The plan approved was "fair and equitable" in accordance with the requirements of the Act.

The major contention of petitioner is that all common stock of Railways should be distributed to the preferred stockholders of Power because the charter of Power provides that, "upon the dissolution or liquidation of the corporation whether voluntary or involuntary," the holders

of preferred stock shall receive $100 per share plus accumulated dividends before any payment is made to the holders of the common stock. (R. 37) Since the asset value of Railways' common stock was not found to be equal to the total principal claim of the preferred stock, $60,000,000, plus a claim for accumulated dividends amounting to $38,700,000, it is the contention of petitioner that the entire common stock of Railways should be distributed to the preferred stockholders of Power. The Commission, however, approved of a distribution of 94.52 per cent of Railways' common to Power's preferred stockholders and 5.48 per cent to Power's common stockholders.

The majority opinion of the Commission held that "the 'fair and equitable' standard does not require us to consider liquidation rights as having matured, and as the sole measure of participation for the preferred stockholders." The opinion continues:

> "More specifically, if a class of preferred stock has a measurable interest in an enterprise absent the maturing of liquidation preferences and a proportionately greater interest upon the maturity thereof, it would not be fair or equitable under the statute to give recognition to the greater interest at the expense and to the detriment of the common stock. And conversely, if the common stock has a measurable interest apart from the maturing of liquidation preferences, we must not sanction the destruction of that interest through the operation of the statutory mandate." (R. 14)

The Commission explains further its disagreement with the dissenting Commissioner and with the argument of petitioner, as follows:

> "It is pointed out in Commissioner Healy's separate opinion that the words 'fair and equitable' embodied in Section 11 have a settled meaning, as determined by the courts, and that an application of the 'absolute priorities' doctrine must result in no distribution to Powers' common stock in this case. But that is because he measures the rights of the preferred stock

> as they would be measured in bankruptcy cases, and not merely because he follows the 'absolute priorities' doctrine in determining the consequences of the measurement. In other words, we can agree with him when he says that absolute priorities must be respected, because we think that doctrine simply means that the common stock must not be accorded any participation unless the preferred stock has been fully compensated for its rights and priorities. But there the area of agreement stops, because he says further that the rights and priorities of the preferred stockholders are the same here as in bankruptcy cases, where their claims to liquidation preferences (including dividend arrearages) are treated as matured. In our view it would be unconscionable and contrary to the plain intention of Congress to so hold." (R. 16)

The foregoing quotations express succinctly the principal issue in the present case. We face at the outset the question as to whether, first, this is a case of dissolution or liquidation of the corporation which was contemplated in the charter provision establishing the rights of the holders of preferred stock upon dissolution or liquidation. It seems evident that it was the intent of the charter provision to provide protection for the preferred stockholders, first in the event that the management of the corporation undertook a voluntary dissolution or liquidation in the ordinary sense; that is, decided to go out of business; or, second, if the management found itself in difficulties and because of the insolvency of the corporation had to liquidate and dissolve it. Certainly there was no thought that the preferred stockholders would have a right to squeeze out the common stockholders if, because of a requirement of the law, it became necessary for the company to be merged or consolidated with another company, or to be eliminated as one of a system of companies in a reorganization which continued the enterprise and the stockholders' investment therein.

We submit that the proposed action is neither a voluntary nor an involuntary dissolution or liquidation as those

words are used in the charter. It is neither a liquidation nor a dissolution of an enterprise, in substance or in fact. It is obviously not a voluntary action; but it is not involuntary in the sense of something compelled as the result of failure or weakness of management. It is not the sort of dissolution or liquidation contemplated by the charter, which would mean the winding up of the business. It is rather a compulsory reorganization to comply with a requirement of law not in contemplation of the parties when the charter was framed and the rights of the preferred stockholders were established. Essentially we have here the frustration of a contract caused by an act of government.

Frustration of a Contract.

It is a well established principle that where the fulfillment of a contract has been made impossible by the exercise of governmental power, exact performance will not be compelled, because the venture has been frustrated. (Restatement of Contracts, Pars. 460, 461.) This principle has been applied in the very case of the dissolution of The United Light and Power Company leading to a judicial decision that upon the retirement of the debentures of this company the debenture holders were not entitled to the payment of a premium in addition to the principal and accrued interest on the bonds. In that case, the Circuit Court of Appeals for the Second Circuit held as follows:

> "Where, through no fault of either party, something necessary for the continued performance of a contract goes out of existence because of some unforeseen circumstance and none of the parties have assumed that risk the contract is regarded as charged with the implied condition that if what is necessary to performance becomes unavailable the contract is no longer binding and further performance is excused. Texas Company v. Hogarth Shipping Co., 256 U. S. 619, 41 S. Ct. 612, 65 L. Ed. 1123; Chicago, Milwaukee & St. Paul R. Co. v. Hoyt, 149 U. S. 1, 13 S. Ct. 779, 37 L. Ed. 625. This is especially true where, as here, the

essential existence of one of the parties to a contract has become illegal and impossible because contrary to a new concept of public policy which was unforeseeable when the contract was made. Holyoke Water Power Co. v. American Writing Paper Co., 300 U. S. 324, 57 S. Ct. 485, 81 L. Ed. 678; Louisville & Nashville R. R. v. Mottley, 219 U. S. 467, 31 S. Ct. 265, 55 L. Ed. 297, 34 L. R. A. N. S., 671." (*New York Trust Company et al. v. Securities and Exchange Com. et al.*, 131 F. (2d) 274, 276) Certiorari denied, 87 L. Ed. Adv. Op. 819, 904.

Of course, in the foregoing case there was a liquidation in fact of the investment of the debenture holders. They were being paid off and their interest in the enterprise terminated. In the present case, the preferred stockholders are not demanding, nor could they be paid, $100 per share and a sum of money equivalent to all accumulated dividends. Nor would the preferred stockholders desire to have the assets sold and the resulting money distributed among them. The preferred stockholders are in thorough accord with the program whereby the debentures and other debts of the corporation are to be paid and then the remaining asset, the common stock of Railways, is to be distributed. In this way, the preferred stockholders maintain their interest in a continuing enterprise. So a question is presented, which is, not the right of the preferred stockholders in an actual dissolution and liquidation of the business in which the corporation is engaged, but the question of what is their fair and equitable share in a continuing enterprise from which simply the corporate entity of Power has been eliminated.

Contract Rights of All Stockholders.

We are here concerned not only with the contract or legal rights of the preferred stockholders, but also with the rights of the common stockholders derived from the provisions of the company's charter and the laws of the State of Maryland. At the time these stockholders invested their funds

in this enterprise, these rights were valid and enforceable rights and we must here consider how these rights have been affected or must be modified as the result of the requirements of Section 11 of the Act. It is not a fair and equitable position to assert that all the rights of the common stockholders have been wiped out and nothing remains to consider but the rights of the preferred stockholders. What is necessary under the law is a fair and equitable adjustment of the interests of all stockholders in view of their respective rights. Let us summarize these.

The principal rights of the preferred stockholders include:

(a) The right to receive $3,600,000 per year in dividends plus any arrears in such dividends before any dividends are paid on the common stock.

(b) The right to certain preferences in the distribution of assets in the event of liquidation or dissolution of the type contemplated at the time the contract was entered into, whether such liquidation or dissolution be voluntary or involuntary.

(c) The right, granted by the laws of Maryland and exercisable by negative vote or by failure to vote, to veto a plan of recapitalization proposed by the common stockholders.

The principal rights of the common stockholders include:

(a) The right to select the management of the Company and to control the Company's affairs whether or not dividends are paid on the preferred stock and without limit as to time.

(b) The right to receive all dividends paid by the Company in excess of $3,600,000 a year.

(c) The perpetual right to use the capital contributed by the preferred stockholders in the conduct of the Company's affairs.

(d) The right to eliminate the preferred stockholders from future participation in earnings by payment of a stipulated redemption price.

(e) The right to continue the business enterprise without limit as to time, provided insolvency does not intervene, which stated negatively, is a right *not* to liquidate.

(f) The right, exercisable by vote or failure to vote, to defer or prevent a recapitalization unless the terms are satisfactory to the common stockholders, which right includes the right to continue operations under the present capital structure no matter how remote may be their prospect of participating in a distribution of earnings.

All the foregoing rights, including those of the preferred stockholders and those of the common stockholders, must yield to the Holding Company Act to the extent that they are inconsistent with the provisions thereof requiring simplification of holding company systems and redistribution of voting power. Thus, solely as a result of congressional action, for which neither party was responsible, the rights of preferred and common stockholders to continue the present capital and corporate structure have terminated. The burden of this congressional condemnation must be borne equitably between the parties, and the Congress specifically so provided by laying down the standard that readjustments required by the Act must be "fair and equitable to the persons affected." (Sec. 11(e))

The court, in the debenture case (131 F. (2d) 274, quoted *supra*), held that where a contract has been frustrated or rendered impossible of performance because of the intervention of the Holding Company Act, senior security holders cannot be enriched at the expense of junior security holders. In that case the debenture holders had a contract right to hold their debentures until 1973 and to collect interest thereon until that date, or an alternative right to receive a premium if the debentures were sooner paid at the election of the company. The stockholders had no contract right to require the debenture holders to accept payment of their debentures prior to the stipulated maturity date. However, the stockholders did have the contract right

to use the bondholders' money until 1973. All of these rights had to yield to the Holding Company Act; and the Commission and the court very properly held that one contract right (the right of the bondholder to collect interest until 1973) could not be enforced in such a manner as to injure the stockholders who had likewise been deprived of their contract right (the right to use the money until 1973).

The rights of both the common and preferred stockholders to insist upon a continuation of their contract or legal rights has ceased because of the Holding Company Act and the Commission's action thereunder. If this event was "unforeseen" by the stockholders and the bondholders, as it was held to be in the debenture case, it was equally "unforeseen" by different classes of stockholders. Under these circumstances, the words "fair and equitable" must mean that existing rights shall be translated into new rights in a manner which will preserve equitably all the existing interests. In brief, the words "fair and equitable" do not permit or require the enforcement or acceleration of a *single* contract right in a manner which will destroy *other* contract rights. Particularly is this so where it appears that the contract right to be enforced or accelerated was not inserted in the contract for the purpose of meeting a contingency of the type which has occurred.

The Commission in effect held that under the existing contract rights the common stockholders have a chance of participating in future earnings without violating the contract rights of the preferred stockholders. The preservation of this right under a revised capital and corporate structure does not involve the transfer of value from the preferred stockholders to the common stockholders. The only feasible way to preserve the common stockholders' right to participate in future earnings is to grant them a portion of the common stock of Railways.

Having in mind the extent to which the Holding Company Act has destroyed the many valuable rights heretofore possessed by the common stockholders, it would seem highly

unreasonable to insist that their right to share in future earnings should also be destroyed. While the Holding Company Act requires the destruction of certain rights of the common stockholders, such as exclusive voting rights, it does not require or permit destruction of rights to participate in future earnings in a case where it is clearly demonstrated that such a right exists. The Commission's conclusions with respect to earning power clearly demonstrate that the common stockholders do have a right to share in those earnings, and for that reason we submit that the preservation of that right does not in any way conflict with the application of the "absolute priority" doctrine.

What is Really "Fair and Equitable"?

To get a clear view of what is fair and equitable, let us consider what would have happened if the management of Power, not under any compulsory requirement, had undertaken to simplify the corporate structure of this holding company system by eliminating Power and distributing the shares of Railways among the preferred and common stockholders of Power. How would the respective claims of the preferred and common stockholders have been appraised? The record shows that the preferred stockholders contributed $60,000,000 in cash. The common stockholders contributed $28,482,745. (R. 72) There were dividends paid of $8,752,796 to common and $10,538,118 to preferred. Even if we deduct the dividends paid to common (but do not deduct the dividends paid to preferred) the common has made a net contribution of $19,729,949.

It also appears (R. 19) that during the period from 1929 through 1942 undistributed consolidated earnings amounted to $51,525,951. If $38,700,000 be deducted to cover accumulated dividends on Power's preferred stock, the balance, $12,825,951, would be applicable to Power's common stock. Thus we find in the enterprise a contribution of original cash ($60,000,000) and unpaid dividends by preferred stockholders amounting to $98,700,000 and an original con-

tribution of $28,482,745 by common stockholders, minus dividends ($8,752,796), plus earnings plowed in ($12,825,951)—a total of $32,555,900.

In the face of these facts regarding the capital contributions of the respective stockholders, would anyone suggest that, upon a reorganization to simplify the corporate structure, the referred stockholders should receive all the assets, that is, all the common stock of Railways, and the common stockholders should receive nothing? No such proposition could be presented by the corporate management with any expectation that it would be regarded as a fair and equitable division; and unless it was so regarded by the common stockholders, they, by exercising their contract and legal rights under the charter and laws of Maryland, could prevent its consummation.

The record shows that, in an effort to comply with the requirements of the Act, the management submitted to the Commission in 1940 a plan of recapitalization and simplification, in accordance with which the preferred and common stocks of Power were reclassified into a single class of new common stock divided substantially as follows: 91.20 per cent to the preferred stockholders; 6.13 per cent to Class A common stockholders and 2.67 per cent to Class B common stockholders. The Commission, however, later instituted proceedings in which the plan of recapitalization and simplification was put aside and an order entered on March 20, 1941 requiring the liquidation and dissolution of Power. In presenting its plan in response to the order of the Commission, the management of Power proposed the same division as in its reorganization plan. The Commission required the share of the preferred stockholders to be increased to the present approved amount of 94.52 per cent.

Looking back over this history, is it not evident that any plan for the reorganization of this enterprise which would wipe out all interest of the common stockholders, notwithstanding their heavy cash investment, could not be regarded as "fair and equitable" in accordance with any or-

dinary understanding of the meaning of those words? The petitioner in the present case is therefore reduced to the necessity of contending that the words "fair and equitable" have an artificial meaning and that according to the absolute priorities rule an unfair and inequitable distribution of all the assets to the preferred stockholders is required.

Now the Commission did not refuse to follow the absolute priorities doctrine. The majority agreed with the dissenting commissioner "that absolute priorities must be respected." But the majority did not agree that "the rights and priorities of the preferred stockholders are the same here as in bankruptcy cases, where their claims to liquidation preferences (including dividend arrearages) are treated as matured." Such a construction of the absolute priorities rule, in the language of the Commission, "would be unconscionable and contrary to the plain intention of Congress." (R. 16)

Before we undertake to discuss the absolute priorities rule, let us consider the intention of the Congress as shown in the language of the Act.

It was certainly the major intention of the Act to protect the interests of investors, not to despoil investors, nor to destroy the value of investments.

In Section 11, it was made the duty of the Commission to simplify the corporate structure of holding company systems, to distribute voting power fairly and equitably, and to confine the properties and business of a system to those necessary and appropriate to the operations of an integrated public utility system. The plan for simplifying a system and conforming it to legal requirements is described in Section 11(d) as "a fair and equitable reorganization plan"; and throughout the section, the words "reorganization plan" and "reorganization" are repeatedly used. The plan presented by Power in the present case, and approved by the Commission, was only one step in a broad reorganization plan. It was only a liquidation and dissolution in the sense that, in the consummation of the

plan, the corporate entity entitled "The United Light and Power Company" would be eliminated. But the plan provides that the investors in that company shall continue in ownership of the same properties which they had owned through the medium of the eliminated corporation. To treat such a reorganization as a bankruptcy liquidation would do violence to the purpose of the Act and be contrary to the fact.

Obviously, the requirement of the Act, that the Commission's approval should be based on a finding that the plan is "fair and equitable to the persons affected by such plan" had a larger meaning than that the Commission should proceed to distribute the assets of a corporation to be eliminated on the same basis as though the corporation had become bankrupt, and as though, not only the corporation but, the entire enterprise had to be liquidated. This Court has defined the meaning of the phrase "fair and equitable" in this section of the law as follows:

> "Determination of what is 'fair and equitable' calls for the application of ethical standards to particular sets of facts, but these standards are not static. In evolving standards of fairness and equity, the Commission is not bound by settled judicial precedents. Congress certainly did not mean to preclude the formulation by the Commission of standards expressing a more sensitive regard for what is right and what is wrong than those prevalent at the time the Public Utility Holding Company Act of 1935 became law. But the Commission did not in this case proffer new standards reflecting the experience gained by it in effectuating the legislative policy. On the contrary, it explicitly disavowed any purpose of going beyond those which the courts had heretofore recognized. Since the Commission professed to decide the case before it according to settled judicial doctrines, its action must be adjudged by the standards which the Commission itself invoked. And judged by those standards, i.e., those which would be enforced by a court of equity, we must conclude that the Commission was in error in deeming its action controlled by established judicial

principles." (*Securities and Exchange Commission* v. *Chenery Corporation*, 318 U. S. 80, 89; 87 L. ed. 411)

Let us now examine the cases upon which the petitioner relies in its insistence that the absolute priority rule be applied in reorganizations under the Holding Company Act in the same manner in which it is applied in the bankruptcy cases.

II.

The absolute priority rule of the bankruptcy cases does not control the Commission's discretion in approving a plan as fair and equitable.

The application and limitations of the absolute priority rule can be determined in the light of the two cases particularly relied upon by petitioner. The first is *Case* v. *Los Angeles Lumber Products Company*, 308 U. S. 105. In that case, the Court held (at page 115), in construing a reorganization under Section 77B of the Bankruptcy Act that:

> "The words 'fair and equitable' as used in Section 77B(f) are words of art which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations. Hence, as in the case of other terms or phrases used in that section, (citations) we adhere to the familiar rule that where words are employed in an act which had at the time a well known meaning in the law, they are used in that sense unless the context requires the contrary." (Citation)
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> "In equity reorganization law the term 'fair and equitable' included, inter alia, the rules of law enunciated by this Court in the familiar cases of (citations). These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans. * * *"

It is quite evident from a reading of the entire opinion that the absolute priority rule which must be observed in any

"fair and equitable" distribution of assets established the principle expressed by the Court (page 120) as follows:

> "* * * 'to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation,' * * *"

It will be at once noted that the rule was not applied to a distribution between stockholders. The preferred stockholders are not creditors of the corporation, but share its ownership with the common stockholders. Their rights to preference over the common stockholders do not arise from an indebtedness of the corporation (i.e., the common stockholders) to them, which should be paid before there is any property left to be distributed to the owners. On the contrary, their rights to preference arise out of contractual relations between the preferred and common stockholders which the Commission is given specific power to reform. For example, in a reorganization, the Commission can take away completely the exclusive voting rights of common stockholders. The contractual rights of the parties cannot be enforced against a finding of the Commission that the exercise of such rights would be in conflict with the requirements of the Act. Thus, the government has to a considerable extent frustrated the original contract between the stockholders. Under the circumstances, the determination of the Commission as to what is fair and equitable cannot be controlled by insistence upon the enforcement of a contract.

It should be apparent that the absolute priority rule laid down in *Case* v. *Los Angeles Lumber Products Company*, *supra*, cannot be held binding upon the Commission so as to control the exercise of its discretion in determining whether the plan for the distribution of the assets of Power between preferred and common stockholders is fair and equitable.

But it is asserted by counsel for petitioner that this Court has held in *Consolidated Rock Products Co.* v. *Du*

Bois, 312 U. S. 510; 85 L. ed. 982, that the absolute priority rule applies to reorganizations of solvent, as well as insolvent, companies. The Court did so hold, and we quote from the opinion at page 527:

> "* * * Whether a company is solvent or insolvent in either the equity or the bankruptcy sense, 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation.'"

So here again we find the definite limitation of the absolute priority rule and the requirement that it be observed in determining whether a reorganization plan is "fair and equitable." The Commission, in the present case, was not concerned with the need to satisfy in full the claims of creditors before permitting any distribution to stockholders. The creditors have been satisfied. The question is, what is a fair and equitable distribution of the assets among stockholders whose holdings all represent actual investments in a continuing enterprise?

The Commission rejected an over-all valuation of the property in a study prepared in behalf of the management by an independent engineer, which the company had brought down to April 30, 1942, reaching an over-all value of $110,000,000. (R. 9) The Commission also found that, by capitalizing prospective earning power, they could not on a "reasonable basis" arrive at a valuation equal to $98,700,000—the amount of the preference claim asserted by present petitioner. Nevertheless, the Commission did find that, on the basis of assumed annual earnings of $6,185,000, the preferred dividend arrearages might be paid in full in approximately fifteen years "if all consolidated net earnings were to be applied toward the payment of current and accumulated preferred dividends." (R. 24) So the Commission, viewing the elimination of Power, not as a liquidation because of financial embarrassment, but as the reorganization of a continuing enterprise, concluded

that the common stock was entitled to some participation, keeping in mind, as was stated, "that there is always a margin of error inherent in any estimate of earning power." (R. 25)

Although the Commission described its estimate of future earning power as "very liberal," attention should be called to the management estimate of $7,000,000 (R. 11), which, in view of pre-depression income and the income of recent years, was not unreasonable. But even accepting the estimated $6,185,000 (which seems more pessimistic than liberal), we point out that 95% of this income will give the preferred stock a 5.95% return on its full claim of $98,700,000—of which $38,700,000 are dividend arrearages, a non-interest bearing claim. Since the Commission's "margin of error" is more likely to be an underestimate than an overestimate of future earning power, we submit that the Commission's conclusion that the common stock was entitled to some participation is fully justified and that its administrative judgment should not be set aside.

It is made plain that the judgment of the Commission as to a fair and equitable division of the interests of preferred and common stockholders in a continuing enterprise was based, first, on the proposition that "the accumulation of preferred dividend arrearages does not constitute a matured claim in the absence of liquidation" (and that this was not a liquidation of the *enterprise* nor the corporate liquidation contemplated in the charter) and second,—

> "To accelerate the arrearages and translate them into matured claims at their full face amount, so as to entitle the preferred stock not only to all the assets but also in perpetuity to the entire earning power of those assets—a portion of which would otherwise have been applicable to the common stock—would clearly be to enrich the preferred at the expense of the common.
>
> "Under the circumstances, fair and equitable compensation will be given to all of the claimants if their rights are measured not in terms of the situation created by the statute but rather in terms of the situation terminated by it—i.e., as though no liquidation were to

take place. In this way each class of stock will be accorded its proportionate share of the benefits to be gained from the elimination of a useless and expensive corporate entity and from the receipt of a security representing a more direct investment in the underlying assets and earnings of the system." (R. 18)

In the opinion of this Court in *Consolidated Rock Products Company* v. *Du Bois*, *supra*, at page 526, a quotation was made with approval from an opinion of Mr. Justice Holmes, in which he stated, "the commercial value of property consists in the expectation of income from it," and the Court went on to hold:

"* * * The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable."

In approving the plan involved in the present case, the Commission found that it could not capitalize prospective earning power so as to reach a value of the property which would cover the claim of the preferred stock of $98,700,000 based on capitalizing $38,700,000 of preferred dividend arrearages. But the Commission held that it would be unfair and inequitable to accelerate the arrearages and translate them into a matured claim in an enterprise which was not being liquidated but continued. Then the Commission found that the prospective earning capacity of the enterprise was sufficient to provide in effect for paying preferred dividends and paying off arrearages in approximately fifteen years, which, if the entire assets were transferred to the preferred stockholders, would mean they would receive for a $60,000,000 investment a property of much greater value, having squeezed out the common stockholders, who, as previously shown, had contributed initially over $28,000,000 and subsequently over $12,000,000 of plowed-in earnings to the up-building of this property.

Under these circumstances, when the Commission found that it would be fair and equitable to allow a distribution of approximately 5 per cent to the common stockholders, it would seem that the only persons who could object to unfairness and inequity, would be the common stockholders. It is not surprising that the owners of all but 10 shares out of 600,000 shares of preferred stock have made no protest against the plan.

III.

Fair and equitable is not a formula but a standard for the exercise of administrative discretion.

In this argument in behalf of the respondent, Power, we have not questioned the soundness of the ruling of the Supreme Court that the words "fair and equitable" as used in Section 77B(f) of the Bankruptcy Act are words of art and that they establish an absolute priority in favor of creditors in the reorganization of a corporation whether solvent or insolvent. We do not question the proposition that a plan of reorganization and simplification under Section 11 of the Public Utility Holding Company Act of 1935 must provide for the full satisfaction of *creditor* claims before the distribution of assets or allocation of interests to corporate owners. It is, however, our contention that, when a distribution of assets and allocation of interests in a continuing enterprise to the original owners is to be made, the standard of "fair and equitable" does not require either the acceleration of preferred dividend arrearages or the satisfaction of a theoretical claim of the preferred stock to a cash payment which cannot be made, by substituting an arbitrary valuation of assets based on their presently assured earning capacity. We submit that, in the adjustment of the respective claims of investors holding common and preferred stock, and in estimating the future earning capacity of the continuing enterprise, the Commission has been invested with a large discretion to determine what is

fair and equitable, not in accordance with any rigid formula but in accordance with its informed judgment.

We also submit that as a practical matter, the approval by the Commission of a plan which is almost unanimously accepted by all the stockholders concerned should determine conclusively that the plan is fair and equitable when there is no rigorous rule of law to coerce the judgment of the Commission, and particularly when the same readjustment of the interests of the stockholders could be carried through under state law without violating any of the contract rights of any of the stockholders.

CONCLUSION.

We submit that the findings of the Commission and the opinions of the District Court and Circuit Court of Appeals demonstrate, first, that there is no violation of the absolute priority rule in the plan approved and, second, that the plan approved was, both in a legal sense and in common sense, fair and equitable.

Respectfully submitted,

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